

## **STP: Shared Growth and Diversification strategy for São Tomé and Príncipe**

### **Background and Context**

São Tomé and Príncipe (STP) is a an archipelago of just over 1,000 square kilometers in the Gulf of Guinea and one of the smallest economies in Africa with some 166,000 inhabitants and a gross national income (GNI) per capita of US\$740. As of 2001, 54 percent of the population lived in poverty, and 15 percent lived in extreme poverty.<sup>1</sup> Despite government instability, all successive governments have implemented policies in line with the PRSP adopted in 2003, most notably on good governance in the nascent petroleum sector and in consolidating macroeconomic stability and poverty reduction. A PRGF program was implemented successfully between 2005 and 2008 which helped the country reach the Completion Point under the Enhanced HIPC Initiative and additional MDRI in 2007 and to receive debt relief of US\$314 million in nominal terms. A new PRGF-supported program was approved in March 2009 which will provide a framework for negotiations currently being held with Portugal to facilitate a peg of the domestic currency (dobra) to the Euro. In 2008, it benefited from a US\$ 6 million World Bank DPO to support public and natural resources revenue management.

Since 2005 the country has received US\$77.8 million in oil bonuses from international oil companies for oil exploration in the joint waters shared with Nigeria. Partial use of these funds has helped close the fiscal gaps since 2005 but has also raised social expectations that are not sustainable in the absence of oil production revenues once oil bonuses run out. Furthermore, macroeconomic projections show that even if STP produces oil, it will require substantial external assistance to bridge the interim period until 2014 when oil exploitation might begin should viable deposits be found off-shore in the meantime. In this context, the authorities want to develop the non-oil economy to avoid over dependency of petroleum revenues.

The country faces many development challenges because of its poverty, small size, insularity and vulnerability to terms of trade and aid dependency, notably: (i) high unit cost of government and utility services; (ii) little flexibility of the economy to adapt to shocks and; (iii) few opportunities for risk diversification inside the domestic market. Production is limited due to small and insular domestic market, with high transaction costs which raises export costs of goods. Tourism has become the most dynamic export sector accounting for about two thirds of total exports earnings.

The export-oriented agricultural sector, mainly cocoa production, has experienced tepid growth and reduced exports.<sup>2</sup> Although agriculture accounted for 15 percent of GDP in 2005, it is still a livelihood for 30 percent of the active population (2003) mostly informally and there is a large potential in the agricultural sector. Nonetheless, food imports have been increasing the last years and the rise in international food and fuel prices in 2008 translated into increasing import costs, a widening of the current account deficit, and an increase in vulnerability. However, as the country is well endowed with fertile soil and abundant water resources and a large rural population, the

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<sup>1</sup> The government will carry out a new household survey with preliminary data expected in October 2009 which will allow for an evaluation of poverty after implementation of the PRSP.

<sup>2</sup> Cocoa typically accounts for over 95 percent of goods exports. Land reform, launched in 1991 and supported by the World Bank and the African Development Bank, was not successful partially because the land was distributed under state concessions and usufructuary rights, which limited access to credits and investment in the sector. Some recent international projects are trying to reverse the dependency on cocoa by introducing high-value-added crops such as pepper and vanilla.

Government wants to develop domestic agriculture and food security with a large impact expected on poverty reduction. To this end it has approved a large Public Investment Program which has yet to be fully articulated and financed.

Poor provision of public utilities is considered one of the main impediments for development, notably expensive and unreliable electricity provision which limits the capacity of the private sector to grow and keep contingent and actual liabilities for the government rising. The energy State Owned Enterprise (EMAE) faces many operational and supervisory challenges, and the Government is considering alternatives to improve efficiency in the sector including private participation. In this context, the government sold in 2008 a controlling stake of 35 percent in the local Petroleum Import Company (ENCO) to Sonangol, the Angolan oil company.

### **1. Objective(s) of the proposed work.**

The objective of the proposal is to analyse the sources of growth in STP using alternative methodologies to understand the macro and microeconomic binding constraints for sustainable and shared growth and the implications for poverty reduction. To this end, the present proposal would finance the following three tasks:

- a) A macroeconomic analysis that will focus in (i) growth decomposition; (ii) binding constraints to growth in STP in light of the approach developed by Hausman, Rodrik and Velasco<sup>3</sup>; and (iii) comparative analysis of macroeconomic management and growth strategies in other small island states.
- b) An analysis of the energy sector to understand binding constraints for private sector development. This analysis will include (i) description of the energy sector, including financial and operational status of the Energy Company and the institutional environment; (ii) lessons learnt in past SOE reforms efforts both in STP and in other small state countries; (iii) output gap measure, i.e. the output loss associated to the unfulfilled electricity demand and the effects on different economic groups.
- c) An analysis of the agricultural sector to foster food security and reduce rural poverty. This analysis will include (i) description of the agricultural sector, including food processing and marketing; (ii) lessons learnt from past agricultural reforms in STP and in other small state countries; (iii) recommendations to lift binding constraints and raise agriculture productivity and food security, starting from the government's own plans for the sector.

### **2. Technical and innovative aspects of the proposed work.**

This work will combine both macro and micro analyses. The first component, related to the analysis of the sources of growth and the main macroeconomic constraints, will use different methodologies (growth decomposition, the “Hausman, Rodrik and Velasco” tool and case studies) to overcome limited data sources and provide recommendations that are tailored to STP features (notably being a small island state). The analysis of the energy sector will consider several methodologies, on the one hand a technical and operational analysis of EMAE, a study of the institutional setting and the ways to raise efficiency, making reference to lessons learnt in other small island states. It will also use techniques to measure the output gap that the energy

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<sup>3</sup> Getting the Diagnosis Right, R. Hausmann, D. Rodrik and A. Velasco, Finance and Development, March 2006, V43, number 1. <http://www.imf.org/external/pubs/ft/fandd/2006/03/hausmann.htm>

constraint is posing on the economic growth and how this burden is shared between different economic groups. Finally, the component on the agriculture sector will overcome the lack of an agricultural census and rely on information available from donor projects and macroeconomic data on food production and consumption. It is expected that the new household survey to be carried out in 2009 will provide key information to analyze distributional effects on alternative agricultural policies.

### **3. Relevance to country priorities.**

The proposed analysis supports the government's efforts to finalize the new National Development Strategy (NDS) that will update the PRSP and aims at developing a diversification strategy to enhance sustainable growth while preparing the economy to potential oil revenues. It will also help the authorities to prioritize policies and action plans for the development of non-oil sectors and their related poverty reduction. This study will also be part of the FY11 Country Economic Memorandum for STP which aims at providing the economic analysis upon which the government can finalize the NDS and upon which Bank interventions will be designed. The analysis comes at a time when the GoSTP is greatly concerned by the country's vulnerabilities and in fact accelerated reforms in the petroleum sector (sale of ENCO) and launched major activities to promote food security.

### **4. Linkages with knowledge sharing, dissemination, and capacity building.**

The main objective of the analysis is to provide key inputs to the development of the new NDS that will be prepared following a participatory approach. Accordingly, it is expected that results of the study will be discussed by the main stakeholders and the final report be broadly publicized through a seminar. The study will also bring in experiences of other small countries and is expected to contribute to the on-going Small States research program lead by the World Bank.

### **5. Client and donor engagement.**

The relevant sector ministries plan to be close partners in the design and the carrying out of the studies, which will also liaise closely with the AfDB and the EU. The counterpart team will comprise government officials led by the Directorate of Planning at the Ministry of Planning and Finance, donors involved in STP and members of the private sector. Key economic agencies that will participate as part of the counterpart team are the Poverty observatory, Ministry of Economy and Commerce, the Central Bank and the Chamber of Commerce.